

STATE OF CALIFORNIA
DEPARTMENT OF INSURANCE
45 Fremont Street, 21st Floor
San Francisco, California 94105

NOTICE OF PROPOSED ACTION AND NOTICE OF PUBLIC HEARING

**SUBCHAPTER 4.11 Residential Property Insurance, Acknowledgment Requirements,
Records Maintenance, Retention, Report**

CDI File No. RH05044911

Date: April 25, 2005

SUBJECT OF HEARING

Notice is hereby given that the Insurance Commissioner proposes to adopt the regulation described below after considering comments from the public. The Commissioner proposes to add to Title 10, California Code of Regulations, Chapter 5, SUBCHAPTER 4.11 *Residential Property Insurance, Acknowledgment Requirements, Records Maintenance, Retention, Report*. The regulation will implement guidelines relating to the rating and underwriting of policies of residential property insurance, including records retention, reporting requirements and certain acknowledgements to be made to consumers prior to the sale of a policy of residential property in insurance

AUTHORITY AND REFERENCE

The authority for the proposed regulation is the express authority conferred upon the Commissioner under Cal. Ins. Code §790.10, implementing, interpreting and making specific Cal. Ins. Code §§790 *et seq.*, the express authority conferred upon the Commissioner under Cal. Ins. Code §1857(i) to implement, interpret and make specific Cal. Ins. Code §§1857 *et seq.*, the express authority conferred upon the Commissioner under Cal. Ins. Code §1857.9(h) to implement, interpret and make specific Cal. Ins. Code §§1857.9, the authority conferred upon the Commissioner under Cal. Ins. Code §1861.05, which provides the commissioner with broad authority relating to the regulation of insurance rates. Reference: Cal. Ins. Code §12926 and *20th Century Ins. Co. v. Garamendi* (1994) 8 Cal. 4th 216, 32 Cal. Rptr. 2d 807, *Calfarm Ins. Co. v. Deukmejian* (1989) 48 Cal. 3d 805, 258 Cal. Rptr. 161, *Smith v. State Farm Mutual Automobile Ins. Co.* (2001) 93 Cal.App.4th 700, *State Farm Mutual Insurance Company v. Harry Low*, (2001) 92 Cal. App. 4th 1169; 112 Cal. Rptr. 2d 574, *State Farm Mutual Automobile Insurance Company v. Garamendi* (2004) 32 Cal. 4th 1029; 88 P.3d 71; 12 Cal. Rptr. 3d 343.

HEARING DATES AND LOCATIONS

The Commissioner will hold a public hearing to provide all interested persons an opportunity to present statements or arguments, either orally or in writing, with respect to this regulation on the following dates at the following locations.

Thursday, July 14, 2005 – 10:30 A.M.
State Building
Milton Marks Auditorium
455 Golden Gate Avenue (Between Larkin and Polk)
San Francisco CA 94102

PRESENTATION OF WRITTEN AND/OR ORAL COMMENTS: CONTACT PERSONS

All persons are invited to present oral and/or written comments at the scheduled hearing. Written comments not presented at the hearing must be addressed to the following contact person:

Donald P. Hilla, Senior Staff Counsel
California Department of Insurance
45 Fremont Street, 21st Floor
San Francisco, CA 94105
Telephone: (415) 538-4108

Questions regarding the hearing, comments or the substance of the proposed action should be addressed to the above contact person. If the contact person is unavailable, inquiries may be sent to the backup contact person:

Lara Sweat, Staff Counsel
California Department of Insurance
45 Fremont Street, 21st Floor
San Francisco, CA 94105
Telephone: (415) 538-4192

DEADLINE FOR WRITTEN COMMENTS

All written materials must be received by the Commissioner, care of the contact person at the address listed above, by no later than **5:00 P.M. on July 7, 2005**. Any materials received after that time will not be considered.

COMMENTS TRANSMITTED BY ELECTRONIC COMMUNICATION

The Commissioner will accept and strongly encourages written comments transmitted by e-mail, provided they are sent to the following e-mail address: hillad@insurance.ca.gov. The Commissioner also requests a hard copy of the comments electronically submitted. Please place the following in the subject heading of the e-mail: **CDI File No. RH05044911**. Microsoft Word documents may be attached to e-mails. The Commissioner will also accept written comments transmitted by facsimile provided they are directed to the attention of **Donald Hilla** using the following fax number: **(415) 904-5490**. Comments sent to other e-mail addresses or other facsimile numbers will not be accepted. Comments sent by e-mail or facsimile are subject to the deadline for written comments set forth above.

ACCESS TO HEARING ROOMS

The facilities to be used for the public hearing are accessible to persons with mobility impairments. Persons with sight or hearing impairments are requested to notify the contact person for this hearing in order to make special arrangements, if necessary.

ADVOCACY OR WITNESS FEES

Persons or groups representing the interests of consumers may be entitled to reasonable advocacy fees, witness fees, and other reasonable expenses, in accordance with the provisions of subchapter 4.5, title 10 of the California Code of Regulations, in connection with their participation in this matter. Persons interested in inquiring about the appropriate procedures should contact the Office of the Public Advisor at the following address:

California Department of Insurance
Office of the Public Advisor
300 Capitol Mall, 17th Floor
Sacramento, CA 95814
(916) 492-3559

A copy of any written materials submitted to the Public Advisor regarding this rulemaking must also be submitted to the contact person for this hearing. Please contact the Office of the Public Advisor for further information.

INFORMATIVE DIGEST

Summary of Existing Law

Cal. Ins. Code §675 defines residential property risks. The proposed regulation refers to this definition in defining the scope of the proposed regulation.

Cal. Ins. Code §676 provides the legal requirements for a valid notice of cancellation and non-renewal of a residential property insurance policy. While not specifically referred to in the proposed regulation insurers may refer to this section in making “negative rating or underwriting decisions” as that term is defined in the proposed regulation.

Cal. Ins. Code §679.71 provides an insurer may not refuse to issue a policy of residential property insurance under conditions less favorable to the potential insured than to other comparable potential insureds. “Conditions less favorable” may include the imposition of higher rates, the rejection of an application, and cancellation and / or nonrenewal of a policy of insurance. The proposed regulation may be relevant to the Commissioner in determining whether the rates, rating plans, rating systems and or underwriting rules applied by an insurer have a unfairly discriminatory impact on specific persons or groups of persons in noncompliance with Cal. Ins. Code §679.71.

Cal. Ins. Code §§790 *et seq.* provides for regulation of various marketing and other practices used in the business of insurance. The stated purpose of Cal. Ins. Code §§ 790 *et seq.*, entitled *Unfair Practices*, is “to regulate trade practices in the business of insurance . . . by defining, or providing for the determination of all such practices in this State which constitute unfair methods of competition or unfair or deceptive acts or practices and by prohibiting the trade practices so defined or determined.”

Cal. Ins. Code §790.10 provides that the commissioner shall promulgate reasonable rules and regulations to administer Cal. Ins. Code §790 *et seq.*, that is, to define prohibited, unfair and deceptive acts or practices. This section provides the Commissioner with the authority to adopt regulations to interpret and make specific Cal. Ins. Code §790 *et seq.* The Commissioner believes that failure to inform insureds and potential insureds of the negative ramifications associated with making a claim is an unfair and deceptive act or practice. This regulation requires insurers to make certain information available to insured and potential insureds.

Cal. Ins. Code §1857(a) requires an insurer to maintain reasonable records, of the type and kind reasonably adapted to its method of operation, of its experience, of the data, statistics, or information collected or used by it in connection with the rates, rating plans, rating systems and underwriting rules . The proposed regulation makes the records requirements in Cal. Ins. Code §1857(a) more specific by detailing exactly the kind of records that must be kept in relation to compliance with the various insurance laws regarding rates, rating plans, rating systems and underwriting rules.

Cal. Ins. Code §1857(i) provides specific authority for the Commissioner to promulgate regulations relating to record keeping.

Cal. Ins. Code §1857.9 provides that the Commissioner may require property and casualty insurers to issue reports.

Cal. Ins. Code §1857.9(h) provides the Commissioner with specific, express, statutory authority to issue rules that identify, define and make specific what information is to be contained in the reports made pursuant to Cal. Ins. Code §1857.9 and to require insurers to issue reports per his instructions as to form, data and information that is required to be reported.

Cal. Ins. Code §1861.03(a) provides that the business of insurance shall be subject to the laws of California applicable to any other business, including, but not limited to, the Unruh Civil Rights Act (Sections 51 to 53, inclusive, of the Civil Code), and the antitrust and unfair business practices laws (Parts 2 (commencing with Section 16600) and 3 (commencing with Section 17500) of Division 7 of the Business and Professions Code). The informational reporting required by the proposed regulation might be relevant to enforcement actions taken pursuant to Cal. Ins. Code §1861.03. The Commissioner has an affirmative duty to enforce this statute. The proposed regulation allows him to gather the information necessary to carry out his duties as required under Cal. Ins. Code §1861.03.

Cal. Ins. Code §1861.05(a) provides that, “No rate shall be approved or remain in effect which is excessive, inadequate, unfairly discriminatory or otherwise in violation of this chapter.” In rating

and underwriting a policy of insurance, where underwriting impacts the rate, insurers must use data that is true and correct. Rates based on incorrect or faulty data are arbitrary. Rates resulting from calculations made using faulty data are excessive, inadequate or unfairly discriminatory. Cal. Ins. Code §1861.05 provides the Commission with broad authority to issue rules of general application in order to regulate rates. Requiring insurers to take reasonable steps to verify data is well within this authority.

In *State Farm Mutual Automobile Insurance Company v. Garamendi* (32 Cal. 4th 1029; 88 P.3d 71; 12 Cal. Rptr. 3d 343; 2004) the California Supreme Court made clear that the Commissioner's authority under Proposition 103 is extremely broad. The court noted that the stated purpose of Proposition 103 is "to protect consumers from arbitrary insurance rates and practices, to encourage a competitive insurance marketplace, to provide for an accountable Insurance Commissioner, and to ensure that insurance is fair, available, and affordable for all Californians." (Historical and Statutory Notes, 42A West's Ann. Ins. Code (1993 ed.) foll. § 1861.01, p. 649.)" The Supreme Court also made it clear that Proposition 103 is "not only about rates and rate regulation; it also concerns other factors that may impermissibly affect the availability of insurance."

Cal. Ins. Code §12926 provides that the Commissioner shall require compliance from every insurer with all the provisions of the Cal. Ins. Code.

See also: *20th Century Ins. Co. v. Garamendi* (1994) 8 Cal. 4th 216, 32 Cal. Rptr. 2d 807, *Calfarm Ins. Co. v. Deukmejian* (1989) 48 Cal. 3d 805, 258 Cal. Rptr. 161, *Smith v. State Farm Mutual Automobile Ins. Co.* (2001) 93 Cal.App.4th 700, *State Farm Mutual Insurance Company v. Harry Low*, (2001) 92 Cal. App. 4th 1169; 112 Cal. Rptr. 2d 574, *State Farm Mutual Automobile Insurance Company v. Garamendi* (2004) 32 Cal. 4th 1029; 88 P.3d 71; 12 Cal. Rptr. 3d 343.

POLICY STATEMENT OVERVIEW

The Commissioner has determined that serious problems exist in the California residential property insurance market. Over the last three years the residential property insurance market has experience periods of extreme availability and affordability problems.

Chief among these problems is the nonrenewal of homeowners insurance policies based only upon the policyholder making a claim. This is referred to by Commissioner Garamendi as the "use it and lose it syndrome." While the practice itself is problematic, almost more troubling is the fact that many policyholders are unaware of the consequences they will encounter should they make a claim against their policy, and they end up losing their insurance due to this lack of information.

As is quoted above the stated purposes of Proposition 103 is to ensure that insurance is fair, available, and affordable for all Californians. The Commissioner has an affirmative duty to monitor the insurance market and to intercede when problems arise. Considerations of fairness and availability come into play when insureds make claims against their policies and suffer retribution for doing so. Considerations of fairness also come into play when policyholders are

not fully informed of the consequences they will suffer upon making a claim. The proposed regulations are intended to address this inherent unfairness.

The stated purpose of the Unfair Practices Act is to “regulate trade practices in the business of insurance . . . by defining, or providing for the determination of, all such practices in this State which constitute unfair methods of competition or unfair or deceptive acts or practices and by prohibiting the trade practices so defined or determined.” The key word here is “unfair.” The Commissioner has determined that it is unfair and deceptive to market insurance products and collect premium without informing insurance consumers about the most basic and fundamental aspects of the policy, including what will happen to the insured should they make a claim against their policy. That is why the proposed regulation requires insurers to inform policyholders and potential policyholders that if they use it they may very well lose it.

Similarly, the Commissioner believes that various negative rating and underwriting practices being engaged in by insurers may be having an unfairly discriminatory impact on certain groups of people in California. The California Insurance Code is very clear that the Commissioner may designate and order insurers to collect and retain any records related to the business of insurance. In this case the data required to be maintained relates to the impact of procedures like “use it and lose it.” The California Insurance Code also makes clear the Commissioner’s authority to order reports of data collected and maintained and as such the proposed regulation designates the content of said reports. The Commissioner is charged with seeing to it that insurance is not marketed in California in an unfairly discriminatory manner and that no specific group of California citizens is treated in a manner dissimilar to other groups of citizens. The proposed regulation is necessary to allow the Commissioner to carry out the duties of his office.

Finally, Proposition 103 gives the Commissioner sweeping and broad authority over rates. A rate that is predicated on incorrect information is, by definition, excessive, inadequate, or unfairly discriminatory. That is why the proposed regulation requires insurers to take reasonable steps to verify the accuracy of data used to rate policies.

Over the last three years a significant numbers of Californians have found it difficult, if not impossible, to purchase residential property insurance in the standard market. Many Californians who have had their policies with the same companies for many years have had their residential property insurance cancelled or nonrenewed. These regulations are designed to address some of the problems associated with this troubled insurance market and to provide for a more robust and vigorous insurance marketplace by increasing competition.

Effect of Proposed Action

As outlined in detail above the proposed regulation will implement, interpret and make specific several California Insurance Code sections that relate to residential property rating and underwriting. The proposed regulation will allow the Commissioner to make important determinations relating to the impact of “use it and lose it” underwriting in California. The regulation will allow insurance consumers to be better informed about the products they are purchasing and similarly allow insurance consumers to make more informed choices as they shop for insurance. Finally, the regulation will facilitate the Commissioner in preventing the

application of excessive, inadequate or unfairly discriminatory rates.

MANDATES ON LOCAL AGENCIES OR SCHOOL DISTRICTS OR COSTS WHICH MUST BE REIMBURSED PURSUANT TO GOVERNMENT CODE SECTIONS 17500 THROUGH 17630

This proposed regulation does not impose any mandate on local agencies or school districts. There are no costs to local agencies or school districts for which Part 7 (commencing with Section 17500) of Division 4 of the Government Code would require reimbursement.

COST OR SAVINGS TO ANY STATE AGENCY

The Commissioner has determined that the proposed regulations will result in no cost or savings to any state agency, no cost to any local agency or school district that is required to be reimbursed, no other nondiscretionary cost or savings imposed on local agencies, and no cost or savings in federal funding to the State.

ECONOMIC IMPACT ON BUSINESSES AND THE ABILITY OF CALIFORNIA BUSINESSES TO COMPETE WITH OTHER STATES

The Department has made an initial determination that adoption of the proposed regulation may have a significant, statewide adverse economic impact directly affecting business, including the ability of California businesses to compete with businesses in other states.

The types of businesses that may be affected are insurers and insurance underwriters. There will be additional record-keeping requirements imposed upon certain insurers that have not been previously required. The Commissioner has not considered proposed alternatives that would lessen any adverse economic impact on business and invites interested parties to submit proposals. Submissions may include the following considerations:

- (i) The establishment of differing compliance or reporting requirements or timetables that take into account the resources available to businesses.
- (ii) Consolidation or simplification of compliance and reporting requirements for businesses.
- (iii) The use of performance standards rather than prescriptive standards.
- (iv) Exemption or partial exemption from the regulatory requirements for businesses.

The types of businesses affected by the proposed regulations are insurers that transact residential property insurance in the State of California.

POTENTIAL COST IMPACT ON PRIVATE PERSONS OR BUSINESSES

The Department is not aware of any cost impacts that a representative private person or business would necessarily incur in reasonable compliance with the proposed action.

EFFECT ON JOBS IN CALIFORNIA

The Commissioner is required to assess any impact the regulations may have on the creation or elimination of jobs in the State of California, the creation of new businesses, the elimination of businesses, and the expansion of businesses currently operating in the state. The Commissioner does not foresee that the proposed regulations will have an impact on any of the above but invites interested parties to comment on this issue.

IMPACT ON HOUSING COSTS

The matters proposed herein will have no significant effect on housing costs.

ALTERNATIVES

The Commissioner must determine that no reasonable alternative considered by the Commissioner or that has otherwise been identified and brought to the attention of the Commissioner would be more effective in carrying out the purposes for which the regulations are proposed or would be as effective as and less burdensome to affected private persons than the proposed action. The Commissioner, however, invites public comment on alternatives to the regulation.

Performance standards were considered. The objective identified was fairness in residential property rating. However, one of the reasons performance standards were rejected was the Commissioner does not, at the present time, have the data needed to determine the standards. The regulation will allow further study that may lead to performance standards in the future.

The proposed regulation is one part of an ongoing process designed to address several ongoing problems in the residential property insurance market. Other alternatives include and have included communication with individual insurers and the industry as a whole, other regulations and legislation. The ongoing program is known as “The Homeowners Bill of Rights.”

Having focused on the problems outlined in this document for over two years the Commissioner believes the proposed regulation represents the best and most viable alternative at the present time.

Finally, the Commissioner continues to study alternatives.

IMPACT ON SMALL BUSINESS

The matters proposed herein will only affect insurance companies, and therefore will not affect small business. (Gov. Code Section 11342.610, subd. (b), para. (2).)

COMPARABLE FEDERAL LAW

There are no existing federal regulations or statutes comparable to the proposed regulation.

TEXT OF REGULATIONS AND STATEMENT OF REASONS

The Commissioner has prepared an initial statement of reasons that sets forth the reasons for the proposed action. Upon request, the initial statement of reasons will be made available for inspection and copying. Requests for the initial statement of reasons or questions regarding this proceeding should be directed to the contact person listed above.

The file for this proceeding, which includes a copy of the proposed regulations, the statement of reasons, the information upon which the proposed action is based, and any supplemental information contained in the rulemaking file, is available for inspection and copying **by prior appointment** at 45 Fremont Street, 21st Floor, San Francisco, California 94105, between the hours of 9:00 a.m. and 4:30 p.m., Monday through Friday. Written requests for the rulemaking file or questions regarding this proceeding should be directed to the contact persons listed above.

FINAL STATEMENT OF REASONS

Upon **written or e-mail** request, the final statement of reasons will be made available for inspection and copying once it has been prepared. Written requests for the final statement of reasons should be directed to the contact person listed above.

AUTOMATIC MAILING

A copy of this notice, including the informative digest, which contains the general substance of the proposed regulations, will automatically be sent to all persons on the Commissioner's mailing list.

WEBSITE POSTINGS

Documents concerning this proceeding are available on the Department's website. To access them, go to <http://www.insurance.ca.gov>. Near the bottom of the page, under "Select a Topic" click on "Consumers". Scroll down to the heading "Regulatory Activity." In this section, scroll down until you see the subheading "Proposed Regulations – Search." Click on the "Proposed Regulations-Search" link. When the "Search" screen appears, you may choose to find the documents by either conducting a search or by browsing for them by name.

To search, enter the Department's regulation file number for these regulations in the "Search for" field. Alternatively, search using as your search term the California Insurance Code number of a code section that the regulations implement (for instance, "1861.05"), or search by key word ("residential" for example). Then, click on the "submit" button to display links to the various filing documents."

To browse, click on the "Browse All Regulations" button near the bottom of the screen. A list of the names of regulations for which documents are posted will appear. Find in the list the "Losses

and Loss Exposure” link, and click it. Links to the documents associated with these regulations will then be displayed.

AVAILABILITY OF MODIFIED TEXT OF REGULATION

If the regulations adopted by the Department differ from but are sufficiently related to the original text, the Department will make the modified text available to the public for at least 15 days prior to the date of adoption. Interested persons should request a copy of these regulations prior to adoption from the contact person listed above.

Dated: April 25, 2005

JOHN GARAMENDI
Insurance Commissioner

By: _____
Donald P. Hilla
Senior Staff Counsel